NDMS-T-1

BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON D.C. 20268-0001

POSTAL RATES AND FEE CHANGES, 1997) Docket No. R97-1

Direct Testimony of

DR. JOHN HALDI

Concerning

THE FIRST-CLASS NONSTANDARD SURCHARGE

on Behalf of

NASHUA PHOTO INC., DISTRICT PHOTO INC.,
MYSTIC COLOR LAB, AND SEATTLE FILMWORKS, INC.

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AUTOBIOGRAPHICAL SKETCH

My name is John Haldi. I am President of Haldi Associates, Inc., an economic and management consulting firm with offices at 680 Fifth Avenue, New York, New York 10019. My consulting experience has covered a wide variety of areas for government, business and private organizations, including testimony before Congress and state legislatures.

In 1952, I received a Bachelor of Arts degree from Emory University, with a major in mathematics and a minor in economics. In 1957 and 1959, respectively, I received an M.A. and a Ph.D. in economics from Stanford University.

From 1958 to 1965, I was assistant professor at the Stanford University Graduate School of Business. In 1966 and 1967, I was Chief of the Program Evaluation Staff, U.S. Bureau of Budget. While there, I was responsible for overseeing implementation of the Planning-Programing-Budgeting (PPB) system in all non-defense agencies of the federal government. During 1966 I also served as Acting Director, Office of Planning, United Stated Post Office Department. I was responsible for establishing the Office of Planning under Postmaster General Lawrence O'Brien. I established an initial research program, and screened and hired the initial staff.

I have written numerous articles, published consulting studies, and co-authored one book. Included among those publications are an article, "The Value of Output of the Post Office Department," which appeared in *The Analysis of Public Output* (1970); a book, *Postal Monopoly: An Assessment of the Private Express Statutes*, published by the American Enterprise Institute for Public Policy Research (1974); an article, "Measuring Performance in Mail Delivery," in *Regulation and the Nature of Postal Delivery Services* (1992); and an article, "Cost and Returns from Delivery to Sparsely Settled Rural Areas," in *Managing Change in the Postal and Delivery Industries* (1997; with L. Merewitz).

I have testified as a witness before the Postal Rate Commission in Docket Nos. MC96-3, MC95-1, R94-1, SS91-1, R90-1, SS86-1, R84-1, R80-1, MC78-2 and R77-1. I also submitted comments in Docket No. RM91-1.

I. PURPOSE OF TESTIMONY

The purpose of this testimony is to present a comprehensive review of the First-Class nonstandard surcharge. A series of rate cases conducted over the past two decades have accepted the nonstandard surcharge without scrutiny. A number of important concerns raised initially by the Postal Rate Commission in Docket No. R78-1 have lain dormant for nearly 20 years — not because they are unimportant, or have ever been resolved, but because neither the Postal Service nor any organized group of mailers has invested the time and resources required to examine either the assumptions undergirding the surcharge or the methodology used to estimate costs.

The initial decision to de-average rates and adopt a surcharge for nonstandard pieces is now over 20 years old. Mail subject to the surcharge is handled very differently in 1997 than it was in the 1970s. In view of the Postal Service's proposed 45 percent increase in the surcharge, the issue of the surcharge should be revisited in its entirety.

Additionally, issues raised by the First-Class nonstandard surcharge have a significance that extends beyond this particular rate category. The matter deserves to be considered afresh and anew by the Commission.

II. INTERVENORS' MAILING PRACTICES AND INTEREST IN THE FIRST-CLASS NONSTANDARD SURCHARGE

This testimony is presented on behalf of four intervenors: Nashua Photo Inc. ("Nashua"), which does business as York Photo Labs, District Photo Inc. ("District") which does business as Clark Color Lab, Mystic Color Lab ("Mystic"), and Seattle FilmWorks, Inc. ("Seattle"), collectively referred to as "NDMS."[1] Each firm is a through-the-mail film processor which receives exposed film through the mail, and uses the Postal Service to return developed film and prints to its customers.

Overview of the Film Processing Industry

Collectively, through-the-mail film processors account for approximately 6 percent of the domestic film processing market. The remaining 94 percent of the market is divided among a large number of local, regional and national (*e.g.*, Eastman Kodak, through Qualex, Inc., and Fuji Photo Film, through Fuji Trucolor Inc.) film processing companies that rely on the general public taking its film to a drop-off location and then returning to the drop-off location to pick up the finished prints. In some localities,

[1] Although not an intervenor herein, another through-the-mail film processor, Skrudland Photo Inc., has joined with and supports the position of NDMS.

competitors do on-site developing and printing, and offer turn-around times as short as one hour.

Turn-around time and service are critical considerations in the direct mail photofinishing business. All four companies operate their respective processing plants up to 24 hours a day, seven days a week, as demand warrants. Their goal is to have finished pictures back into the mail within 24 hours after customers' film arrives at the plant.

Nashua, District, Mystic, and Seattle compete vigorously with each other, but they compete even more with the multitude of local, regional and national film processors described above.

Mailing Practices of Nashua, District, Mystic, and Seattle

Unexposed rolls of 35mm film are supplied in light-proof cartridges placed inside plastic canisters. When mailing exposed rolls of film, some customers drop the cartridge containing exposed film directly into an envelope, while others place the cartridge back in the plastic canister before mailing. When a single cartridge of 35mm film is returned without the canister, it usually weighs less than one ounce and is therefore subject to the First-Class nonstandard surcharge. When the plastic canister is used, the package weighs more than one ounce and is therefore subject to the rate for two-ounce First-Class Mail. Envelopes sent to NDMS that contain a cartridge of film and weigh less than one ounce constitute a significant

portion (perhaps as much as one-fourth) of the 24.9 million nonstandard single-piece First-Class parcels that weighed less than one ounce in 1996.

Mystic and Seattle supply all their customers and prospects exclusively with specially-designed business reply envelopes ("BREs") to be used when placing an order. All BREs supplied by Mystic and Seattle are returned directly to each firm at their respective plants. On all incoming BRE mail, Mystic and Seattle thus pay all applicable First-Class postage, including the First-Class nonstandard surcharge.

Nashua and District receive both BREs and reply envelopes with postage prepaid by the customer. When customers use BREs, Nashua and District pay all applicable First-Class postage, including the First-Class nonstandard surcharge. For single rolls of film without canisters which are under one ounce, when reply envelopes are prepaid by customers, they are supposed to include the surcharge. Many customers overpay, by putting two 32-cent stamps or a 32-cent and 23-cent stamp on the envelope. Other customers underpay, by putting only one 32-cent stamp on the envelope. In the former situation, the Postal Service retains the overpayment; in the latter situation, the Postal Service collects the nonstandard surcharge from Nashua or District as postage due.

In this docket, the Postal Service proposes to increase the rate for the first ounce of First-Class Mail from 32 to 33 cents, or by **3.1 percent**. At the same time, the Postal Service proposes to increase the nonstandard

surcharge by 5 cents, from 11 to 16 cents, or by **45 percent**. In the context of an omnibus rate case that calls for an overall rate increase of **4.5 percent**, a 45 percent increase is a ten-fold increase over the systemwide average and can only be described as creating enormous "rate shock."[2]

[2] The magnitude of this 45 percent increase is exceeded only by the increases of up to 55.6 percent proposed by the Postal Service for Standard A parcels, and the proposed increases for registered mail. Witness Moeller, in his response to NAA/USPS-T36-4 (Tr. 6/2777), stated: "If DSCF-entered minimum-per-piece 3/5-digit residual shape is considered a separate rate category, then the proposed increase for this category is the highest at 55.6 percent." The fact that NDMS are heavy users of **both** First-Class nonstandard mail and DSCF-entered Standard A parcels makes the rate shock on these mailers even worse.

III. THE BASIS FOR THE NONSTANDARD SURCHARGE NEEDS TO BE RE-EXAMINED

The 1973 Decision to Implement a Shell Classification for a Surcharge on Nonstandard First-Class Mail

Shell classification. In Docket No. MC73-1, the Commission recommended that a nonstandard surcharge be established for First-Class, Airmail and third-class single piece mail, to be implemented two years following the date the *Opinion and Recommended Decision* was issued (April 15, 1976).[3] The Commission also recommended that "the structure and amount or amounts of any surcharge shall be determined later following a rate request made pursuant to 39 U.S.C. §3622."

Definition of nonstandard mail. Nonstandard mailpieces were defined as having any:

(a) height-to-length ratio outside 1:1.3 and 1:2.5, inclusive, or

(b) height exceeding 6.125 inches, or

(c) length exceeding 11.5 inches, or

(d) thickness exceeding 0.25 inches.

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[3] *Op. & Rec. Dec.*, Docket No. MC73-1, pp. 25-29.

Within First-Class and Airmail, the surcharge was applied to nonstandard letters, flats, and parcels under one ounce.[4] The Commission noted that whenever mail in any of these categories exceeds the first weight step, revenues are sufficient to cover extra costs.[5]

Machinability considerations. Looking toward the future, the Commission determined that "mechanization requires that some definition of maximum size be specified **for purpose of machine design and procurement.**" *Op. & Rec. Dec.*, Docket No. MC73-1, p. 26 (emphasis added). The Commission also noted that "mail that is too small or flimsy tends to jam the mail processing machines and damage other mail.[6] Oversize pieces...can be handled without detriment to machines or other mail because they can be culled from the mailstream, but the cost of handling is greater." *Id.*, p. 25, n.1. The surcharge was intended to encourage use of standard size

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[4] The definition of nonstandard First-Class Mail has not changed; *see* response of witness Fronk to NDMS/USPS-T32-22 (Tr. 4/1503).

[5] The Commission has recognized in past dockets that the rate charged for incremental ounces of First-Class Mail exceeds a reasonable estimate of the incremental cost caused by additional weight of mail pieces. *See, inter alia, Ops. & Rec. Decs.*, Docket No. R94-1, para. 5030 and Docket No. R80-1, para. 658.

[6] Of course, the Postal Service has addressed the concern of mailpieces that are too small by establishing minimum dimensions for mailpieces (0.007" thick, DMM C010.1.3) and more particularly, for letters (not less than 3.5" high or 5" long, DMM C010.1.2, or not less than 0.009" thick for letters more than 4-1/4" high or 6" long, or both, DMM C810.2.1.c.(2)). Failure to meet these minimum standards makes the mailpiece **nonmailable**. The Postal Service has also addressed concerns of flimsiness by establishing minimum standards for packaging (DMM C010.2.0) and containers (DMM C010.3.0).

mailpieces, and was expected to reduce postal costs and/or increase postal revenues.

Establishment of Rates for the Surcharge[7]

Initial rate. In Docket No. R78-1 (*Opinion & Recommended Decision on a Surcharge for Nonstandard Mail*), the Commission rejected a Postal Service proposal to establish a nonstandard surcharge of 13 cents, instead recommending a nonstandard surcharge of 7 cents.

Subsequent rates. Since Docket No. R78-1, the Postal Service has updated the study that purports to provide the cost basis for the nonstandard surcharge. A series of incremental increases have resulted in the current single piece rate of 11 cents. In Docket No. R87-1, a reduced surcharge of 5 cents per piece was implemented for **presorted** First-Class Mail.

The Nonstandard Surcharge Needs Critical Re-examination

Advances in automation and mechanization. The surcharge represents an early de-averaging of rates within single piece First-Class Mail. Since the surcharge was first imposed, however, a comprehensive review of the general rationale and the basis for the surcharge has not been undertaken. There are good reasons to do so. For example, new sorting

[7] Throughout this testimony, references to "the surcharge" should be interpreted to refer only to the existing surcharge on nonstandard First-Class Mail.

machines, of the type which the Commission anticipated in its Docket No. R78-1 *Opinion and Recommended Decision* (and some perhaps even more advanced than any contemplated by the Commission), have been widely deployed, without any corresponding study by the Postal Service of whether or how nonstandard mailpieces are processed on them.

The latest equipment for processing letters includes the Advanced Facer Canceler System ("AFCS"); optical character readers ("OCRs") that read typed addresses, print barcodes and sort letters; a variety of barcode sorters ("BCSs"), including some that can sort mail to a carrier's walk sequence; and remote video equipment for encoding letters that cannot be read on an OCR. Whether nonstandard pieces, such as square letters, can be processed efficiently on currently installed equipment clearly needs review.

The Postal Service has not submitted any evidence as to the processing of nonstandard mailpieces. As an experiment, I personally purchased 10 Christmas cards whose envelopes measured exactly 5" square (clearly nonstandard with a 1.0 aspect ratio), placed a 32-cent stamp on each, and had them mailed to me from various locations in New York City and Chicago. Of these, nine were received[8] with cancellation and barcodes, which

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[8] The cards are contained in Library Reference LR-NDMS-1. Nine were to have been mailed between November 24 and December 2; one was mailed on December 18. One was never received, but I have been unable to confirm that it was actually mailed.

(continued...)

evidenced machine processing.[9] One envelope was torn along the top edge. This was the only envelope which may have offered evidence of **malprocessing**. (None were marked postage due, either.) On the basis of this small sample, witness Daniel cannot be right when she states that "they [nonstandard letters] would all be manually sorted."[10] (Emphasis added.) If nothing else, this small-scale experiment shows the need to review the nonstandard surcharge in terms of existing automation and mechanization capabilities.

Specifications for pieces that can be sorted on the FSM 1000 indicate that flats under one ounce ("flimsies") are well within its limitations.[11] The average weight of a flat subject to the First-Class nonstandard surcharge is

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[8](...continued)
The library reference also includes two Christmas card envelopes, received at my office, which were not part of the experiment, both of which were machine processed, and neither of which were presented with a request for additional postage. One card, 5 9/16" square, was mailed from Washington, D.C. The other card, 6 7/16" x 6 11/16" (an aspect ratio of 1.04), was mailed from Hong Kong.

[9] Despite evidence to the contrary, the responses of witness Moden to NDMS/USPS-T4-17-18 (Tr. 11/5816-17) indicate that nonstandard pieces are incompatible with the Advanced Facer Canceler System.

[10] Tr. 14/7471, l. 4.

[11] LR-H-169, p. 1 and Postal Service response to NDMS/USPS-T26-3, 4 and 10 (Tr. 19-B/8930-31, 8937-38). The last-cited interrogatory states that "[q]ualitatively, virtually all mail that is within the specifications of the FSM 1000 is processed successfully." The preceding statement conflicts with witness Moden's response to NDMS/USPS-T32-18(b) (Tr. 11/5825) which says that many flats under one ounce "have difficulty meeting the other machinability requirements such as rigidity." Of course, there are no rigidity requirements for First-Class flats other than for those entered at the automation rate.

0.8 ounces.[12] Even flats under one-tenth of one ounce fell within the specifications for the FSM 1000 used in the 1992 Albany, New York test. The production model FSM 1000 currently being deployed (100 were deployed in FY 1997, and an additional 240 are scheduled for deployment in FY 1998)[13] can process flats weighing 0.32 ounces.

All known standard size flat envelopes appear to be well within the weight specifications of the production FSM 1000. By way of experiment, five typical flat-sized envelopes available for sale at Office Depot, Staples, and Kinko's Copies in McLean, Virginia were purchased. Using a Pitney-Bowes Model A500 digital scale, which rounds to tenths of an ounce, the empty envelopes were weighed, and no standard off-the-shelf envelope weighed less than the FSM 1000's 0.32 ounce minimum. The measurements and weights for the five envelopes appear in the following chart:

Envelope	Measurements	Empty Weight
Quality Park Tyvek	9.5" x 12.5"	0.4 ounces
Westvāco Grip-Seal	9" x 12"	0.6 ounces
DuPont Tyvek	9" x 12"	0.5 ounces
Manila Clasp	9" x 12"	0.4 ounces
Catalog Mailer	6.5" x 9.5"	0.4 ounces

[12] Response of Postal Service to NDMS/USPS-ST43-16(c) (Tr. 19-B/8897).

[13] Response of witness Moden to DMA/USPS-T4-89 (Tr. 11/5759).

(These envelopes are filed as LR-NDMS-2.)

Yet within the context of the nonstandard surcharge, no studies or analyses have been conducted by the Postal Service concerning the effect of the ongoing mechanization program on the definition of First-Class nonstandard flats.[14] In fact, the FSM 881 has no stated minimum weight specifications. Also, while there are various tested malprocess rates for both the FSM 881 and the FSM 1000 for nonstandard pieces, no evidence exists that the malprocessed pieces were flimsies.[15] No study of flimsies was ever conducted.[16] The questions of whether existing automation equipment can handle nonstandard letters and whether mechanized equipment can handle flimsies need careful examination. Moreover, technology is not static: the Postal Service has stated that "New Design Flat Sorting Machines are

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[14] *See* Postal Service response to NDMS/USPS-T32-28 (Tr. 19-B/8956). The question of what can and cannot be handled on Postal Service mail processing equipment needs to be revisited periodically. Apart from incremental improvements in existing automated equipment, the opportunity to adapt entirely new technologies also exists. The introduction of robots is spreading rapidly in industries that have a high proportion of labor-intensive handling tasks involving odd-shaped workpieces *(e.g.*, the automobile industry), preparing the ground for robots in postal processing, where no reason exists to anticipate a new order of difficulties.

[15] *See* Postal Service response to NDMS/USPS-T26-4(c) (Tr. 19-B/8931). *See also* Tr. 18/8239, ll. 8-12.

[16] *See* Postal Service response to NDMS/USPS-T26-4(d) (Tr. 19-B/8931). *See also* Tr. 18/8239, l. 17, and Postal Service response to NDMS/USPS-T32-9 (Tr. 14/7406).

planned for deployment by the end of FY 1999."[17] Even some parcels can be handled by the FSM 1000, which can handle mailpieces as thick as 1.25".

Incentives to mailers. It is generally understood that prices send signals to consumers. In this context, the surcharge may give mailers a signal that can be viewed as some sort of incentive.

In order for the surcharge to constitute an effective signal, mailers must first know that the surcharge exists. In this regard, it is worth noting that the Postal Service makes little effort — and no special effort — to publicize the existence of the surcharge,[18] and it has no documentation evidencing underpayment or overpayment of the nonstandard surcharge.[19] The Postal Service does not even sell an 11-cent stamp (the current amount of the surcharge).[20]

To the extent that the general public is aware of the surcharge, the incentive effects are unclear. Parcel mailers, for example, generally cannot convert their mailpieces to a flat or letter shape. And witness Fronk denies

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[17] *See* response of witness Moden to NDMS/USPS-T4-19 (Tr. 11/5818-19).

[18] Responses of Postal Service to NDMS/USPS-T32-43 (Tr. 19-B/8965) and OCA/USPS-T32-8 (Tr. 19-D/9333).

[19] Response of Postal Service to OCA/USPS-T32-15 (Tr. 19-D/9340).

[20] Response of witness Fronk to OCA/USPS-T32-47 (Tr. 4/1659-60).

any intent to create an incentive that would convert pieces of nonstandard shape to pieces of standard shape.[21]

Inconsistency of principles. More generally, no consistently-applied principles — based either on cost or volume — have emerged over the past 20 years to support continued de-averaging of single piece First-Class rates, either by discounts or surcharges. The special attention given nonstandard one-ounce-or-less mailpieces leaves the impression of arbitrariness and unfairness.[22] In contrast to the Postal Service's labored attempts to justify this surcharge — which affects less than 1 percent of First-Class Mail — the huge disproportion between rates and attributable costs for First-Class pieces weighing more than one ounce has been allowed to continue as an integral part of the rate structure, with no apparent concern for the lack of cost-based justification.

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[21] Response of witness Fronk to NDMS/USPS-T32-25 (Tr. 4/1504-05).

[22] To the extent the Postal Service has any consistently applied "principle," it would appear to be "take the money and run." In terms of rate design, this translates into the (i) abolition of discounts, and (ii) preservation and expansion of surcharges.

IV. NONSTANDARD FIRST-CLASS VOLUMES AND REVENUES ARE MINIMAL

Nonstandard Volume and Revenue in 1996

Volume. The 1996 volume of nonstandard First-Class Mail was estimated to be 383 million pieces.[23] The vast majority, 326 million, or 85 percent, consists of single piece mail sent by the general mailing public. The other 57 million pieces were mailed at presort rates. *See* Table 1.

Revenues. The nonstandard surcharge was estimated to have raised approximately $35 million in 1996, of which presort and carrier route nonstandard pieces accounted for just under $3 million. The Postal Service estimates that only 90.4 percent of nonstandard single piece mail pays the surcharge. This number may be very optimistic based on my sample mailing

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[23] See response of Postal Service to NDMS/USPS-T32-29 (Tr. 14/7415). However, responses of Postal Service to NDMS/USPS-2 (Tr. 14/7371-72) and NDMS/USPS-T32-47 (Tr. 19-B/8970-72) provided dramatically different estimates of nonstandard parcels and flats, respectively, as well as compliance factors. The volume of nonstandard First-Class Mail is so small that the Postal Service apparently does not have reliable data. The Postal Service concedes that the lack of quality data may arise from the fact that many clerks do not recognize a nonstandard piece when they see one. Such inconsistency or inability to identify nonstandard pieces may also explain how the share of nonstandard letter volume dropped from 58 percent to 19 percent in the Postal Service's analysis. *See* Tr. 14/7429, ll. 14-18. *See also* Tr. 14/7467, ll. 8-9: "If data collectors aren't recognizing letter pieces as nonstandard, I have no way of knowing that." Indeed, if data collectors do not recognize nonstandard pieces, clerks are not likely to either, and most nonstandard mail could be expected to be processed along with other First-Class Mail at no additional cost.

of 10 pieces where none paid the surcharge, and the fact that even trained data collecting personnel do not recognize these pieces.[24]

[24] The issue of enforcement was addressed when the surcharge was first imposed in Docket No. R78-1. The Commission decided that enforcement was not feasible in a cost-effective manner. Enforcement costs estimated at $13 million were expected to generate only $4.3 million in additional revenues; thus, spending on enforcement was not deemed to be an exercise in "prudent management."

Table 1

Volume and Estimated Revenue
From Nonstandard First-Class Mail
BY 1996

	Volume (millions)					Estimated Revenue
	Letters (1)	Flats (2)	Parcels (3)	Total (4)	Surcharge (5)	(000) (6)
Single Piece	62.7	238.0	24.9	325.6	$0.11	$35,816
Compliance Factor						x .904
Net revenue from single piece surcharge						$32,378
Presort	9.1	38.4	2.1	49.6	0.05	2,480
Carrier Route	1.8	6.0	0.2	8.0	0.05	400
TOTAL	73.6	282.4	27.2	383.2		$35,258

Source: Columns 1-4 and compliance factor from NDMS/USPS-T32-29 (Tr. 14/7415).

Note: Nonletters ceased to be eligible for Carrier Route rates during BY 1996, following implementation of the rate and classification changes of Docket No. MC95-1 on July 1, 1996.

Nonstandard Volume in Perspective

Single piece nonstandard mail. The 326 million pieces of nonstandard First-Class single piece mail represented only 0.60 percent of all First-Class single piece mail (*see* Table 2). In 1996, revenues from the nonstandard surcharge represented only 0.15 percent of First-Class single piece revenue. For all First-Class Mail, the $35.3 million in revenue was only 0.11 percent of total revenues of $31.9 billion.

Presort nonstandard mail. The 11 million First-Class nonstandard 3/5-digit **presort** pieces mailed in 1996 constituted only 0.14 percent of all First-Class 3/5-digit **presort** volume (carrier route included), and **carrier route** nonstandard pieces were 0.28 percent of all **carrier route** pieces (*see* Table 2). Within presort mail, revenues from the nonstandard surcharge represented only 0.03 percent of total revenues.

Volume of presort First-Class Mail. In Docket No. R77-1, presort categories for 3/5-digit and carrier route First-Class Mail were first introduced. These two rate categories also represent a de-averaging of costs and rates. They constitute 38.8 and 3.1 percent, respectively, of total First-Class Mail volume (*see* Table 2). It seems eminently sensible to recognize such a substantial percentage as a separate rate category, especially when the percentage represents tens of billions of pieces of mail. The 42 percent of total presort volume contrasts sharply with nonstandard volume, which is well under 1 percent.

Heavy-weight presort First-Class Mail. Some 300 million pieces of heavy-weight (over two ounces) First-Class Mail currently receive a presort discount of 4.6 cents per piece. Witness Fronk proposes to eliminate this First-Class rate category on grounds that (i) the volume is not sufficient to

warrant separate treatment, and (ii) simplification of the rate structure would be preferable.[25]

Witness Fronk's analysis of the heavy-weight presort discount is probably correct. Separate rate classes for segments that constitute small fractions of 1 percent of First-Class Mail do not honor the Postal Reorganization Act's mandate of simplicity.[26] The comparable volume of nonstandard First-Class Mail likewise argues for abandonment of that surcharge.

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[25] USPS-T-32, p. 25, and Tr. 4/1624, l. 15 to 4/1625, l. 5.

[26] The "simplicity of structure" mandate merits the greatest force when applied to First-Class single piece mail, which is perhaps the mail product most heavily used by the least sophisticated mailers.

Table 2

Nonstandard Share of First-Class Mail

A. BY 1996 VOLUME

	Total Pieces (million)	Distribution (percent)	Non-Standard (million)	Non-Standard Share (percent)
Single Piece	54,150.8	58.1%	325.6	0.60%
3/5-Digit Presort	36,213.6	38.8	49.6	0.14
Carrier Route	2,843.6	3.1	8.0	0.28
TOTAL	93,208.0	100.0%	383.2	0.41%

B. BY 1996 REVENUES

	Total (million)	Distribution (percent)	Non-Standard (million)	Non-Standard Share (percent)
Single Piece	$21,194.1	66.2%	$32.4	0.15%
3/5-Digit Presort	10,050.3	31.4	2.5	0.03
Carrier Route	754.9	2.4	0.4	0.05
TOTAL	$31,999.3	100.0%	$35.3	0.11%

Note: Nonletters ceased to be eligible for Carrier Route rates during BY 1996, following implementation of the rate and classification changes of Docket No. MC95-1 on July 1, 1996.

V. COST DATA SUPPORTING THE FIRST-CLASS NONSTANDARD SURCHARGE ARE NOT CREDIBLE

Postal Rate Commission's Critique of Foundations of Nonstandard Surcharge

In Docket No. R78-1, which established the original nonstandard surcharge rates, the Postal Rate Commission noted that the data and assumptions on which the entire nonstandard surcharge rate structure then rested (and continues to rest even today) are:

> distorted by the inability to exclude costs pertaining to First-Class Mail over one ounce which is not subjected to the surcharge. [*Op. & Rec. Dec.*, p. 26, continuation of n. 1 from p. 25.]

Yet, over the past two decades the Postal Service has undertaken no studies to remedy this serious distortion identified by the Commission. The Postal Service has simply updated the defective data, with all their shortcomings, aided by mailer inattention, using the flawed analysis and results again and again as the basis for proposed increases, including the current one.[27]

Witness Daniel, in her late-filed supplemental testimony, USPS-ST-43, presenting the Postal Service's latest updates of additional mail

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[27] Only some of the defective cost data have been updated on a periodic basis. Until the present docket, the Postal Service made no effort to update data on the obviously stale volume shares by shape of nonstandard mail, or even disclose that it was stale in its presentations to the Commission.

processing costs associated with nonstandard First-Class pieces, makes the following candid admission:

> One limitation of the analysis presented here **is our inability to determine the cost differences of just one-ounce nonstandard pieces**. The mail flow model presented in Exhibit USPS-43B can only be used to determine the cost of an average weight letter. Inputs are not available to determine costs by specific ounce increments. Whereas it might be possible to estimate the average mail processing cost of a one-ounce letter, flat, or parcel using the methodology presented in USPS LR-H-106, it is not possible to determine the cost of processing a one-ounce letter-shaped nonstandard piece. [USPS-ST-43, pp. 2-3, emphasis added.]

For reasons stated by witness Daniel, for cost estimation purposes the missing data are replaced by "proxies," or substitute variables that purport to represent the variables for which they stand. The key issue to be reviewed here is the degree of distortion introduced into the cost estimates of nonstandard pieces by the proxies used, which the Postal Service states are the only available proxies.

Distortion of Cost Estimates by the Proxies Used

Postal Service data used as proxies to support the nonstandard surcharge are shown in Table 3.

Table 3

Cost Data Used to Support the Nonstandard Surcharge

	Standard Letters	Proxy For Non-Standard Letters	Proxy For Non-Standard Flats	Proxy For Non-Standard Parcels
Average Cost (cents)	11.74	20.54	32.66	74.57
Average Weight (ounces)	0.5	0.5	3.3	4.3

Actual Data of Under One-Ounce Mailpieces

	Non-Standard Letters	Non-Standard Flats	Non-Standard Parcels
Average Weight (ounces)	0.65	0.80	0.49

Sources: Exhibit USPS-43A
Response of witness Daniel to NDMS/USPS-ST43-11 (Tr. 14/7389).
Response of Postal Service to NDMS/USPS-ST43-16 (Tr. 19-B/8897).

Letters. The average weight of a First-Class nonstandard letter is 0.65 ounces.[28] The average weight of the proxy for nonstandard letters is 0.5 ounces.[29] Therefore, in terms of one factor, weight, the average cost for letters may represent a reasonably good proxy.

[28] Response of Postal Service to NDMS/USPS-ST43-16 (Tr. 19-B/8897).

[29] Response of witness Daniel to NDMS/USPS-ST43-11 (Tr. 14/7389).

The proxy fails, however, when the method of processing is considered. The proxy for nonstandard letters is the cost of letters sorted manually; *i.e.*, it is **assumed** that **all** nonstandard letters are **always** sorted manually.[30] To the extent that ***any*** nonstandard letters are in fact sorted on automated equipment, the proxy overstates the mail processing cost of nonstandard letters. As noted previously, a simple test mailing ten 5" square cards shows that nonstandard pieces can be, and in fact are, (i) canceled on the Advanced Facer Canceler System and (ii) sorted on automation equipment.

Flats and parcels. For flats and parcels, the average weight of the proxy is multiples of the average weight for the subset of pieces of less than one ounce.[31] Moreover, flats and parcels actually subject to the surcharge were but a small portion of the flats and parcels studied and relied upon to support the proposed increase in the First-Class nonstandard surcharge. In

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[30] Response of witness Daniel to NDMS/USPS-ST43-17 (Tr. 14/7394-95); *see also* Tr. 14/7456, l. 19. No evidence exists that nonstandard First-Class letters cannot be processed on automation equipment or that they are all culled from the automation mail stream. *But see* Tr. 14/7447, ll. 11-17, where witness Daniel speculated that, given two similar letters, one of which was nonstandard, "since these are both so borderline, both may go through or he pull [sic] both of them..." and Tr. 14/7487, l. 21 to 14/7488, l. 2:

> Q: You know that anything that doesn't wind up with its tip in the shaded area will jam an OCR. Is that your testimony?
> A: No sir, just that there's a greater likelihood that it would.
> Q: And what's your authority for that proposition?
> A: The fact that it was deemed nonmachinable.

[31] The average weights of First-Class single piece flats and parcels are, respectively, 0.80 ounces and 0.49 ounces. *See* response of Postal Service to NDMS/USPS-ST43-16 (Tr. 19-B/8897).

1996, only 7.1 percent of all single piece flats and 8.0 percent of all single piece parcels weighed under one ounce.[32]

Using average weight First-Class flats and parcels as proxies for under-one-ounce flats and parcels, respectively, is indefensible. Such proxies are wholly inadequate to represent the variables for which they substitute, **unless one adopts the position that weight has no effect on cost.** The average weight in 1996 for single piece flats was 3.3 ounces, while for single piece parcels it was 4.3 ounces. Thus the proxies were more than 4 and more than 8 times, respectively, the average weight of the pieces that they purport to represent.[33]

Even more significantly, the additional cost of handling an under-one-ounce nonstandard flat or parcel is almost wholly unrelated to the cost of handling the proxy (*i.e.*, an average weight flat or parcel). This can be readily seen because: (i) the proxy's handling cost would change whenever the distribution and average weight of parcels or flats weighing between 2 and 11 ounces changes; (ii) such changes in handling costs of the proxy would

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[32] Response of Postal Service to NDMS/USPS-T32-8(d) and (e) (revised 9/30/97) (Tr. 19-B/8951).

[33] For presort flats and parcels, the averages are 2.50 and 1.51 ounces, respectively. Response of Postal Service to NDMS/USPS-T32-8(b) (Tr. 19-B/8951). For carrier route flats, the average is 1.54 ounces, as calculated from the Attachment to response of Postal Service to NDMS/USPS-T32-47 (Tr. 19-B/8972); there are too few carrier route parcels to calculate a meaningful average for them. The overall weighted averages for all flats and parcels are 3.22 and 4.25 ounces, respectively, as calculated from the Attachment to response of Postal Service to NDMS/USPS-T32-47.

not correlate with or reflect any changes in the cost of handling mailpieces that weigh under one ounce; and (iii) average parcel costs are further distorted by the presence of certain odd shapes (*e.g.*, rolls) and contents (*e.g.*, live chicks) that are quite expensive to handle, are found in the population of the proxy, and are never found in the population of one-ounce-or-less parcels. Accordingly, no functional relationship exists between the handling costs of the proxies and the variables for which they purport to stand. The analysis based on these proxies is totally inadequate to support the Postal Service's existing First-Class nonstandard surcharge, let alone the proposed increase. The Commission's critique in Docket No. R78-1 concerning the distortions introduced into the process of rate making "by the inability to exclude costs pertaining to First-Class Mail over one ounce" remains as applicable and incontrovertible today as it was almost 20 years ago. The above conclusion is valid even though, as mentioned by witness Daniel in her supplemental testimony,[34] regarding Docket No. R90-1:

> the Commission was satisfied with the Nonstandard surcharge Library Reference presented in Docket No. R90-1 upon which the analysis in this docket [No. R97-1] is based. In its Opinion and Recommended Decision, the Commission noted: "It is satisfying to observe that in this case the Service has provided solid information on the comparative costs of standard and nonstandard First-Class pieces."

[34] USPS-ST-43, p. 3, ll. 10-16.

The preceding quotation may reflect the lack of scrutiny given the surcharge by any intervenor in that docket, and must be viewed in the context of the **Commission's own earlier critique, cited above from Docket No. R78-1, which was precisely on target and was never addressed** in subsequent Postal Service cost revisions submitted in Docket Nos. R84-1, R94-1, or R97-1 — as well as Docket No. R90-1, cited by witness Daniel. **The data in Docket No. R90-1, on which the Commission inexplicably commented favorably, were subject to the same identical distortion that the Commission itself criticized in Docket No. R78-1.**[35]

Can Better Data Be Expected Soon?

As a final note, the likelihood of obtaining the data required to specify the additional cost of handling an under-one-ounce nonstandard mail piece needs to be addressed. This likelihood appears minimal, because it would require a major reorganization of, as well as supplementation to, existing

[35] Moreover, in 1990 only the flawed cost data were updated. Other data on the proportion of nonstandard letters, flats and parcels were taken from a report in the early seventies, using data possibly predating creation of the Postal Service, and by 1990 they were already stale and out of date. *See* USPS-ST-43, p. 2, ll. 12-13.

Postal Service data collection systems and procedures. The IOCS does not collect any information about nonstandard pieces of First-Class Mail.[36]

The required change may not be beyond the realm of possibility, but it would certainly be hard to justify simply for the purpose of constructing credible cost-based rates for less than 1 percent of First-Class Mail volume.[37] Reluctance of the Postal Service to undertake a major cost study to remedy the existing situation is understandable in light of the expense such a study would entail, together with limited importance of the First-Class nonstandard surcharge within the overall rate structure. Thus, credible cost data to support the First-Class nonstandard surcharge do not exist, nor are they likely to become available any time in the foreseeable future.

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[36] Response of Postal Service to NDMS/USPS-T32-48 (Tr. 19-B/8973).

[37] If the Postal Service wants to achieve First-Class rates that are more cost-based, it should study the broader issue of the relationship between cost and weight for all First-Class Mail.

VI. FIRST-CLASS FLATS AND PARCELS ARE PROFITABLE PRODUCTS

In light of the severe problems associated with determining the actual costs incurred by handling nonstandard First-Class Mail, discussed in the preceding section, it is worth noting that First-Class flats and parcels, taken as individual groups, are profitable products that make more than an adequate contribution to covering Postal Service costs — as do, of course, First-Class letters taken as a group.

Available Data on Flats and Parcels

As the Postal Service candidly admits, no reliable estimate exists for the cost of handling First-Class flats and parcels that weigh under one ounce. The only available data are **average** costs for **all** flats and **all** parcels. Although the desired cost data are not available, the data that are available can be used, in conjunction with other data provided by the Postal Service,[38] to compare revenues and cost for all single piece flats and parcels. Such a comparison is instructive (*see* Table 4).

[38] Attachment to response of Postal Service to NDMS/USPS-T32-47 (Tr. 19-B/8972).

Table 4

First-Class Single Piece Flats and Parcels
Revenues, Mail Processing Costs and Volumes
(excluding surcharge)
BY 1996

	(1) Flats	(2) Parcels
Revenue (000)	$3,925,784	$535,736
Less: mail processing and delivery costs (000)	1,538,926	355,472
Contribution to other costs (000)	$2,386,860	$180,264
Volume (000)	4,111,364	449,505
Average contribution/piece	$0.58	$0.40
Coverage of mail processing and delivery costs	255.6%	150.7%

Source: Appendix, Table A-1.

Average Revenue of First-Class Single Piece Flats is 58 Cents Greater Than Mail Processing and Delivery Costs Without Any Surcharge

The revenue data in Table 4 have been computed without the surcharge on pieces under one ounce. As can be seen from column (1) in Table 4, **excluding the surcharge**, flats on average **generate revenues of 58 cents per piece** over mail processing and delivery cost, which is equal to **255 percent**. Each of these figures substantially exceeds the comparable

contribution and coverage, respectively, for an average weight, standard-sized, single piece First-Class letter.[39]

At 23 cents per additional ounce, which is equivalent to $3.68 per pound, the fee for extra ounces on flats enables the Postal Service to recoup handsomely any possible (yet unproven) loss that it may incur on account of flimsies. If light-weight flats are to be de-averaged in pursuit of rates that are more cost-based, then fairness and equity (as well as consistency) call for a corresponding reduction in the extra-ounce rate applicable to heavier-weight flats (as well as to letters and parcels), which are grossly overcharged *in relation to cost.*[40]

Average Revenue of First-Class Single Piece Parcels is 40 Cents Greater Than Mail Processing and Delivery Costs Without Any Surcharge

The situation with respect to parcels is similar, although somewhat less striking than it is for flats. **Without any surcharge,** parcels generate revenues of **40 cents per piece over mail processing and delivery costs,**

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[39] Single piece letters have an average mail processing cost of 11.74 cents (Exhibit USPS-43A) and a delivery cost of 5.00 cents (Exhibit USPS-29C). A single piece letter thus contributes only 15.26 cents to other costs and the coverage of mail processing and delivery cost equals 191 percent.

[40] A reduction of at least 3 cents, from 23 to 20 cents per additional ounce, which is equivalent to $3.20 per pound, would be appropriate. By way of comparison, even this reduced pound rate is more than 5 times the pound rate proposed for Standard A Regular.

which far exceeds the average comparable revenues from letters. The coverage of mail processing and delivery cost is **151 percent.**[41]

Minimal Aggregate Effect of Nonstandard Surcharge

Addition of the existing 11-cent surcharge scarcely changes the profitability analysis for flats or parcels. For single piece flats, the contribution per piece increases from 58 cents to 59 cents, while coverage of mail processing and delivery cost increases from 255 to 257 percent. For single piece parcels, the contribution to the other costs increases from 40 cents to 41 cents, and coverage of mail processing and delivery cost increases from 151 percent to 152 percent.[42] Flats and parcels presorted to 3/5 digits and carrier route are also quite profitable (*see* Appendix, Table A-2 for details).

In conclusion, flats and parcels are both profitable products that make excellent contributions to Postal Service cost coverage, even without the surcharge. In fact, the surcharge has a negligible effect on the overall profitability of either product; its continuation cannot be defended on grounds of prudent management. Assessing a surcharge on the small

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[41] NDMS each receive and pay all postage and fees on a substantial number of First-Class parcels whose weight exceeds one ounce, which are clearly quite profitable for the Postal Service. Growth in the use of disposable cameras is increasing the average weight of parcels received by NDMS.

[42] *See* Appendix, Table A-1 for details.

segment of mailpieces whose revenue is low in comparison to costs, while charging an additional $3.68 per pound (pro-rated on a per-ounce basis) for heavier pieces which undergo similar mail processing and have similar cost characteristics, simply underscores the arbitrariness of de-averaging tiny segments of these profitable groups without a compelling operational need.

Broader issues of fairness and equity in de-averaging decisions play a key role in considering whether to continue the First-Class nonstandard surcharge. These broader issues of de-averaging are discussed in the next section of this testimony.

VII. THE DE-AVERAGING OF RATES FOR SINGLE PIECE FIRST-CLASS MAIL HAS NO CONSISTENT, PRINCIPLED BASIS

Need for Guiding Principles

Cost-driven de-averaging can be applied to distinguish any subsegment of mail whose average processing cost differs significantly from the average processing cost of the segment as a whole, supporting the creation of additional rate categories. Of course, the quest for more cost-based rates can justify any and all de-averaging, however wise or foolish it may be.

The key issue is: under what conditions should rate categories be created and such de-averaging built into the rate structure? De-averaging First-Class Mail should not be undertaken lightly. Once the "de-averaging genie" is out of the bottle in First-Class, legitimate issues directly related to the nonstandard surcharge arise. A few examples follow.

- What are the criteria for de-averaging?
- Should there be separate rates (or a surcharge) for all First-Class flats and parcels?
- Should there be separate rates (or a surcharge) for hand-addressed pieces, or for pieces that are not automation-compatible?
- Should there be a separate rate or discount for local mail that is deposited in the "local mail" slot of a post office and receives final delivery to an addressee from the post office where it is deposited?

- Should a discount or reduced rate apply to single pieces that are fully automatable?
- Should there be a discount for metered mail?
- Should there be a discount for single piece "clean" mail, whether metered or stamped?

De-Averaging Versus Simplification

It is hard to escape the conclusion that the Postal Service is less than consistent in its rate-making proposals in this docket; it argues either of two inconsistent principles, de-averaging or rate simplification, in an *ad hoc* manner, so long as the result will increase revenue. Thus, while favoring (without justifying) continued de-averaging with a 45 percent increase in the First-Class nonstandard surcharge, witness Fronk simultaneously proposes to simplify the rate structure by eliminating the 4.6 cent per-piece discount given to some 300 million pieces of presorted heavy-weight (over 2 ounce) First-Class Mail.[43]

Note that the volume in the **presorted heavy-weight** rate category is almost the same as the volume of **nonstandard non-presort** pieces, and is five times the volume of **nonstandard presorted** pieces (*see* Table 1).[44]

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[43] *See* USPS-T-32, p. 25, l. 2; *see also* Tr. 4/1624, l. 15 to 4/1625, l. 5.

[44] More exactly, the volume was 344 million pieces, based on the response of Postal Service to NDMS/USPS-T32-47 (Tr. 19-B/8970-72).

Strong exception must be taken to such practices. The Postal Service's rate proposals and the resulting *ad hoc* exercises in averaging or de-averaging fly in the face of 39 U.S.C. Section 3622(b)(1), "the establishment of a fair and equitable rate schedule." A sensible approach would be to recognize that a multiplicity of tiny (under 1 percent of total volume) rate categories within First-Class Mail has limited value, and abolish both the surcharge and the discount at this time. If simplicity of structure means only one rate category should be kept, it should be the presorted heavy-weight discount, which is available only to sophisticated presort mailers. Simplicity of structure argues most strongly for elimination of the nonstandard surcharge, which applies to the entire mailing public.

Cost Drivers as a Basis for De-Averaging

If the Commission contemplates continued support for the type of de-averaging represented by the nonstandard surcharge, there are additional cost-drivers which may provide useful bases for de-averaging:

Weight. Within single piece First-Class Mail, the cost to process, transport and deliver a piece of mail varies widely. One cost driver, weight, has been an integral part of the First-Class rate schedule for as long as

anyone can remember. For many years, mailers have paid for each additional ounce.[45]

To an important extent, weight has been considered as a proxy for shape. That is, as weight of single piece First-Class Mail increases, the percentage of letters falls sharply, while the percentage of flats and parcels increases. When de-averaging introduces cost drivers other than weight (such as shape, or automatability, or "cleanness," for example) into the rate schedule, the role assigned to existing cost drivers, especially any that currently act as a proxy for the newly introduced variable, need to be reexamined critically.

Automatability. In recent years, address incompatibility with the latest generation of mail processing equipment has become an increasingly important cost driver. Hand-addressed letters (and fancy fonts now available on computers) that cannot be read by today's OCRs have a higher unit cost. Such letters must be encoded on remote barcoding equipment. If, for any reason, mail cannot be read on remote barcoding equipment, it needs to be manually sorted at an even higher cost than letters that receive remote barcoding.[46] The cost of sorting letters manually is based on both standard

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[45] In colonial times, before scales were widely available, it was customary to charge for each sheet of paper in a letter or packet, rather than charge by weight as such.

[46] *See* response of witness Moden to NDMS/USPS-T32-21 (Tr. 11/5826) for (continued...)

and nonstandard letters. Of all letters that are still sorted manually by the Postal Service, nonstandard letters may represent only a small proportion.[47]

Automatability is not static. While the DMM definition of "nonstandard" may not have changed for many years, the capabilities of mail processing technology have changed dramatically. Furthermore, they continue to evolve. Advances in automation could easily undermine one fundamental premise for the surcharge asserted by the Postal Service (but rejected by the Commission) – namely, that all nonstandard letters are always handled manually. As noted previously in this testimony, many nonstandard letters may now be routinely handled as expeditiously (and at the same cost) as standard-sized letters.[48] Also, flimsies may be processed routinely on the FSM 1000 along with other flats, all at the same cost. Flimsies are clearly within the specifications of the existing FSM 1000, while a New Design Flat Sorting Machine is to be deployed in the near future.

To sum up, the nonstandard surcharge has been imposed because the mail to which it applies is believed to have a cost that is considered high in relation both to other mail and to the rate which is charged for such mail in

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[46](...continued)
examples of standard-sized letters subject to manual processing.

[47] Volumes that are still sorted manually are not known; *see* response of Postal Service to NDMS/USPS-T32-31 (Tr. 19-B/8959).

[48] LR-NDMS-1 contains some evidence to this effect.

the absence of the surcharge. But nonstandard pieces are not the only First-Class Mail with a unit cost purportedly somewhat higher (or lower) than the mean, or benchmark. Single piece First-Class rates could be de-averaged further, perhaps much further, on the basis of a variety of cost drivers.

De-Averaging Versus Balkanization

De-averaging, and the quest for cost-based rates, has merit. De-averaging on the basis of cost is a hallmark of highly competitive markets. At the same time, however, it should be kept in mind that (i) the Postal Service has a statutory monopoly on First-Class Mail; (ii) the one class of mail that is available to every resident without restriction and that is widely used by the general mailing public is First-Class Mail; and (iii) simplicity of rate structure is one specific criterion of rate setting enumerated in 39 U.S.C. Section 3622(b). Since the Act also mandates that one class of mail sealed from inspection (a definition of First-Class Mail) have rates that are uniform throughout the nation, de-averaging of First-Class Mail should be approached conservatively and should be based on clear and well-documented reasons.[49]

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[49] 39 U.S.C. §3623(d) requires that there be one class of mail for transmission of letters sealed against inspection, whose rates shall be uniform throughout the country. In a layman's interpretation, uniform rates presumably means, at a minimum, no transportation differential. Whether it also means that rates should be uniform with respect to shape, or automatability, or other cost-driving

(continued...)

The Commission should give serious consideration to the advisability of maintaining any rate category that constitutes well under 1 percent of volume — and one-tenth of 1 percent of revenue — of First-Class Mail. If the Commission were to affirm the surcharge, this precedent could be used to justify almost limitless "balkanization" of First-Class Mail. Moreover, it could open the door to doing so in a seemingly arbitrary fashion, since any fine-tuning of costs and rates that may be achieved by reliance on the nonstandard surcharge contrasts sharply with the enormous disparity that is known to exist between the cost incurred by additional ounces and the rate for additional ounces (23 cents per ounce, the equivalent of $3.68 per pound).

Summary

The Commission needs to develop some well-articulated principles with respect to de-averaging and the creation of rate categories within First-Class Mail. Appropriate principles to guide de-averaging decisions within First-Class Mail might be the following:

- De-averaging of First-Class Mail segments should be undertaken only when:

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[49](...continued)
characteristics is an interesting question. Strictly speaking, the answer requires a definition or interpretation of "uniform" as it is used in the Act, which is a legal issue beyond the scope of my testimony. I would note, however, that ever since Sir Rowland Hill introduced the first prepaid postage stamp in England, the mailing public has employed — and enjoyed — a rate structure based on simplicity and uniformity.

- a **substantial proportion** of the volume or revenue can be de-averaged;

- the cost basis for de-averaging is **solid and credible**; and

- the result achieved will greatly exceed any increase in complexity.

VIII. CONCLUSIONS AND RECOMMENDATIONS

Conclusions

The First-Class nonstandard surcharge de-averages rates for a trivial percentage of First-Class Mail, both single piece and presort. Its continuance at this time opens the door to almost limitless de-averaging within the one subclass that is widely used by the general public and intended by Congress, as evidenced by 39 U.S.C. §3623(d), to enjoy uniform rates throughout the nation. The additional revenues provided by the surcharge, seen in the context of $32 billion in total revenues for First-Class Mail, offer a classic example of the concept ***de minimis***.

The cost data used to support the surcharge are fatally flawed. Simply put, in its effort to justify an additional $35 million in revenue from the surcharge, the Postal Service's analysis implicitly assumes that (i) all nonstandard letters are manually processed and (ii) additional weight has absolutely no effect on the cost of First-Class Mail. The first assumption is demonstrably false. *See* LR-NDMS-1. Of course, if the second assumption is **valid**, then the Postal Service cannot escape the conclusion that it collects over $4 billion in revenues from the 23-cent rate on additional ounces of First-Class Mail without any cost justification whatsoever. And if the

implicit assumption is **not valid**, then clearly the cost study used to support the surcharge is fatally flawed and should be ignored.

Primary Recommendation

For the foregoing reasons, the Commission is urged to eliminate the nonstandard surcharge. Elimination of the surcharge would materially simplify the First-Class rate structure with negligible loss of revenue and, perhaps more importantly, would reduce the arbitrariness of this part of the First-Class rate structure.

Secondary Recommendation

If the Commission does not wish to eliminate the surcharge at this time, then it is urged to reject any increase in the surcharge pending the Postal Service's completion of a complete review of the basis for the surcharge. Any such study should analyze the extent to which letters and flats now classified as nonstandard can be and in fact are being processed, respectively, on automated and mechanized equipment. The study should also address the effect of weight on cost of First-Class Mail, and review all findings in this respect against any surcharge based either on shape, or a combination of shape and weight. The Postal Service should also:

- calculate malprocessing rates and costs, and incorporate such figures into its calculations;

- accurately identify costs incurred by the average under-one-ounce nonstandard letter, flat, and parcel; and
- address the inability of Postal Service personnel to identify such mailpieces correctly.

Until such study is complete, the Commission should reduce the nonstandard surcharge by the following means:

(i) Specifically exclude the deeply flawed proxies consisting of the average costs of handling flats and parcels, respectively, from any role in the computation.

(ii) Use only reasonably reliable data to compute the extra cost of nonstandard First-Class Mail. Among the proxies used in the Postal Service's supporting calculations, the difference between the average cost of First-Class letters (11.74 cents) and the cost of a manually processed letter (20.54 cents)[50] is arguably a somewhat reasonable proxy for use with nonstandard pieces, **provided** the Postal Service demonstrates that all or most nonstandard letters are indeed processed manually.[51] Under this approach, the extra cost is conservatively estimated at no more than 8.80 cents.

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[50] USPS-ST-43, Exhibit USPS-43A.

[51] Of course, the use of this proxy in no way addresses the lack of consistency in de-averaging the tiny nonstandard segment while continuing the massive averaging associated with the one-ounce incremental rate.

(iii) Apply a much reduced passthrough, preferably of 50 percent, in view of the multiple objections surrounding the justifiability of the surcharge. Fairness and equity would in any event suggest a comparatively low passthrough, consistent with passthroughs on other shape-based cost differences, such as the letter-flat differential applied to Standard A Mail, as well as the Postal Service's proposed parcel surcharge, also on Standard A Mail.[52] With a 50-percent passthrough, the nonstandard surcharge would be computed at 4.40 cents, which could be rounded either up or down, resulting in a surcharge on the order of four to five cents.

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[52] In Docket R90-1, the Commission recommended rates that recognized 50 percent of the letter/flat differential in third-class regular mail (except in basic, where the passthrough was 62 percent). *Op. & Rec. Dec.*, para. 5941. The corresponding passthrough was approximately 25 percent in nonprofit. *Id.*, para. 5943.

In this docket, the Postal Service proposes no recognition of the letter-flat differential in Basic ECR, while proposing 35 percent passthroughs for the other ECR density tiers. USPS-T-36, p. 27.

APPENDIX

This appendix consists of two tables, similar in construction. First, using volume data by one-ounce increments, estimated revenues for flats and parcels are computed both without and with the surcharge. Second, total costs are computed from unit cost data. Third, total contribution, contribution per piece, and coverage of mail processing and delivery costs, are computed. The tables contained in this appendix are as follows:

Table	
A-1	First-Class Single Piece Flats and Parcels
A-2	First-Class 3/5 Digit Presort Flats and Parcels

Table A-1

First-Class Single Piece Flats and Parcels
Base Year 1996

	Distribution of pieces by weight increment												Revenue Without	Plus	Revenue With
	1	2	3	4	5	6	7	8	9	10	11	Volume	Surcharge	Surcharge	Surcharge
FLATS															
Pieces (000)	292,120	1,290,925	843,810	522,874	358,457	249,391	179,655	137,469	105,648	75,028	55,987	4,111,364			
Postage/pc. (cents)	32	55	78	101	124	147	170	193	216	239	262				
Revenue ($, 000)	93,478	710,009	658,172	528,103	444,487	366,605	305,414	265,315	228,200	179,317	146,686		3,925,784	32,133	3,957,918
Average processing cost/piece (cents)													32.43		
Delivery cost (cents)													5.00		
Total cost ($, 000)													1,538,925		
Total contribution ($, 000)													2,386,860		2,418,993
Contribution per piece (cents)													58.06		58.84
Coverage of MP+D cost													255.1%		257.2%

	Distribution of pieces by weight increment												Revenue Without	Plus	Revenue With
	1	2	3	4	5	6	7	8	9	10	11	Volume	Surcharge	Surcharge	Surcharge
PARCELS															
Pieces (000)	36,028	77,273	75,625	56,515	45,204	37,245	31,007	27,622	24,768	20,927	17,290	449,504			
Postage/pc. (cents)	32	55	78	101	124	147	170	193	216	239	262				
Revenue ($, 000)	11,529	42,500	58,988	57,080	56,053	54,750	52,712	53,310	53,499	50,016	45,300		535,736	3,963	539,700
Average processing cost/piece (cents)													74.08		
Delivery cost (cents)													5.00		
Total cost ($, 000)													355,472		
Total contribution ($, 000)													180,264		184,227
Contribution per piece (cents)													40.10		40.98
Coverage of MP+D cost													150.7%		151.8%

Source of pieces by weight increment: Attachment to NDMS/USPS-T32-47 (Tr. 19-B/8970-72).
Source of mail processing and delivery cost: USPS-ST-43 and USPS-29C (revised 10/1/97), respectively.

Table A-2

First-Class 3/5 Digit Presort Flats and Parcels
Base Year 1996

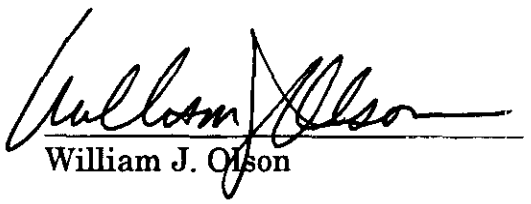
	Distribution of pieces by weight increment												Revenue Without	Plus	Revenue With
	1	2	3	4	5	6	7	8	9	10	11	Volume	Surcharge	Surcharge	Surcharge
FLATS															
3/5 Flats (000)	27,509	74,082	90,135	31,498	6,387	4,730	2,851	2,230	1,731	1,659	845	243,657			
Postage/pc. (cents)	25.8	48.8	67	90	113	136	159	182	205	228	251				
Revenue ($, 000)	7,097	36,152	60,390	28,348	7,217	6,433	4,533	4,059	3,549	3,783	2,121		163,682	1,375	165,057
Residual flats (000)	14,305	25,551	19,855	6,089	2,399	2,655	2,044	2,082	1,807	1,527	869	79,183			
Postage/pc. (cents)	27.4	50.4	68.6	91.6	114.6	137.6	160.6	183.6	206.6	229.6	252.6				
Revenue ($, 000)	3,920	12,878	13,621	5,578	2,749	3,653	3,283	3,823	3,733	3,506	2,195		58,937	715	59,653
TOTAL												322,840	222,619	2,091	224,710
Average processing cost/piece (cents)													20.87		
Delivery cost (cents)													5.00		
Total cost ($, 000)													83,522		
Total contribution ($, 000)													139,097		141,188
Contribution per piece (cents)													43.09		43.73
Coverage of MP+D Costs													266.5%		269.0%

	Distribution of pieces by weight increment														
	1	2	3	4	5	6	7	8	9	10	11				
PARCELS															
3/5 Parcels (000)	4,870	350	2,657	146	73	136	78	20	23	10	18	8,381			
Postage/pc. (cents)	25.8	48.8	67	90	113	136	159	182	205	228	251				
Revenue ($, 000)	1,256	171	1,780	131	82	185	124	36	47	23	45		3,882	244	4,125
Residual parcels (000)	266	46	194	48	55	28	63	11	2	15	33	761			
Postage/pc. (cents)	27.4	50.4	68.6	91.6	114.6	137.6	160.6	183.6	206.6	229.6	252.6				
Revenue ($, 000)	73	23	133	44	63	39	101	20	4	34	83		618	13	631
TOTAL												9,142	4,500	257	4,757
Average processing cost/piece (cents)													21.96		
Delivery cost (cents)													5.00		
Total cost ($, 000)													2,465		
Total contribution ($, 000)													2,035		2,292
Contribution per piece (cents)													22.26		25.07
Coverage of MP+D Costs													182.6%		193.0%

Source of pieces by weight increment: Attachment to NDMS/USPS-T32-47 (Tr. 19-B/8970-72).
Sources of mail processing and delivery cost: USPS-ST-43 and USPS-29C (revised 10/1/97), respectively.
Revenue calculations do not reflect rate increases implemented in fourth quarter of BY 1996 (on July 1, 1996) pursuant to Docket No. MC95-1.

CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon all participants of record in this proceeding in accordance with Section 12 of the Rules of Practice.



William J. Olson

December 30, 1997